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Date:

June 21, 2005

Legend:

X =

Y =

State =

Year 1 =

Date 1 =

A% =

business 1 =

investments =

business 2 =

Dear :

This letter is in response to your request, dated March 8, 2005, on behalf of X, seeking a ruling regarding passive investment income under §1362(d)(3) and §1375 of the Internal Revenue Code.

Facts

Based on the materials submitted and representations within, we understand the relevant facts to be as follows. X was incorporated in Year 1 in accordance with the laws of State and is engaged in the active trade of business 1. X also earns income from investments, which are considered to be §1362(d)(3) passive investment income. X made an election to be treated as an S corporation effective Date 1. Thus, X has accumulated earnings and profits (AE&P) from prior years.

In order to diversify, X purchased interests in Y, a publicly traded partnership which is engaged in the active trade of business 2. It is anticipated that the income from X's interests in Y will provide approximately A% of X's annual gross receipts. X represents that Y meets the qualifying income exception of section 7704(c) and, thus, is taxed as a partnership for federal income tax purposes. X also represents that Y is not an electing large partnership as defined by section 775 and, thus, the normal flowthrough provisions of subchapter K apply to their partners.

Law and Analysis

Section 1361(a)(1) defines an "S corporation" as a small business corporation for which an election under § 1362(a) is in effect for the taxable year.

Section 1362(d)(3)(A)(i) provides that an election under § 1362(a) shall be terminated whenever the corporation has accumulated earnings and profits at the close of each of three consecutive taxable years, and has gross receipts for each of the taxable years more than 25 percent of which are passive investment income. The termination is effective on and after the first date of the first taxable year beginning after the third consecutive taxable year referred to in § 1362(d)(3)(A)(i). Section 1362(d)(3)(A)(ii).

Except as otherwise provided in § 1362(d)(3)(C), § 1362(d)(3)(C)(i) provides that the term "passive investment income" means gross receipts derived from royalties, rents, dividends, interest, annuities, and sales or exchanges of stock or securities.

Section 1375 imposes a tax on the income of an S corporation that has accumulated earnings and profits at the close of a taxable year, and that has gross receipts more than 25 percent of which are passive investment income (within the meaning of § 1362(d)(3)).

Section 702(a) provides that, in determining income tax liability, each partner shall take into account separately his distributive share of the partnership's items of income, gain, loss, deduction, and credit to the extent provided by regulations.

Section 1.702-1(a)(8)(ii) provides that each partner must take into account separately his distributive share of any partnership item that would result in an income tax liability for that partner different from that which would result if that partner did not take the item into account separately.

Section 702(b) provides that the character of any item of income, gain, loss, deduction, or credit included in a partner's distributive share under section 702(a)(1) through (7) shall be determined as if the item were realized directly from the source from which realized by the partnership, or incurred in the same manner as incurred by the partnership.

Section 7704(a) provides that, except as provided in subsection (c), a publicly traded partnership shall be treated as a corporation.

Section 7704(b) provides that the term PTP means any partnership if interests in that partnership are traded on an established securities market or are readily tradable on a secondary market (or the substantial equivalent thereof).

Section 7704(c)(1) provides that subsection (a) shall not apply to any publicly traded partnership for any taxable year of such partnership meets the gross income requirements of paragraph (c)(2) for such taxable year and each preceding taxable year beginning after December 31, 1987, during which the partnership (or any predecessor) was in existence. Section 7704(c)(2) states that a partnership meets the gross income requirements of this paragraph for any taxable year if 90 percent or more of the gross income of such partnership for such taxable year consists of qualifying income.

Section 7704(d)(1)(E) provides, in relevant part, the term "qualifying income" means income and gains derived from the exploration, development, mining or production, processing, refining, transportation (including pipelines transporting gas, oil, or products thereof), or the marketing of any mineral or natural resource (including fertilizer, geothermal energy, and timber). For purposes of this section, mineral or natural resource means any product of a character with respect to which a deduction for depletion is allowable under section 611, but is not a product described in section 613(b)(7)(A) or (B).

Rev. Rul. 71-455, 1971-2 C.B. 318, deals with an S corporation that operates a business in a joint venture with another corporation. In the tax year at issue, the total business expenses exceeded gross receipts. The revenue ruling holds that, in applying the passive investment income limitations, the S corporation should include its

distributive share of the joint venture's gross receipts and not its share of the venture's loss. In accordance with section 702(b), the character of these gross receipts were not converted into passive investment income upon their allocation to the S corporation.

X's distributive shares of gross receipts from Y, if separately taken into account, might affect its federal income tax liability. Under section 1362(d)(3), the status of X as an S corporation could depend upon the character of its distributive shares of gross receipts from Y. Thus, pursuant to section 1.702-1(a)(8)(ii), X must take into account separately its distributive shares of the gross receipts from Y. The character of these partnership receipts for X will be the same as the character of the partnership receipts for Y, in accordance with section 702(b).

Conclusion

Based solely upon the representations made and the information submitted, we conclude the following: (1) X's distributive shares of the gross receipts of Y will be included in its gross receipts for purposes of sections 1362(d)(3) and 1375(a); and (2) X's distributive shares of Y's gross receipts attributable to the exploration, development, mining or production, processing, refining, transportation (including pipelines transporting gas, oil, or products thereof), or the marketing of any mineral or natural resource will not constitute passive investment income as defined by section 1362(d)(3)(C).

Except as specifically ruled upon above, no opinion is expressed as to the federal income tax consequences of the facts described above under any other provision of the code. In particular, no opinion is expressed or implied as to whether X otherwise qualifies as a subchapter S corporation under § 1361. Furthermore, the passive investment income rules of section 1362 are completely independent of the passive activity rules of section 469.

This ruling is directed only to the taxpayer who requested it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

In accordance with the Power of Attorney on file with this office, a copy of this letter ruling will be sent to your authorized representative.

Sincerely,

David R. Haglund
Senior Technician Reviewer, Branch 1
Office of the Associate Chief Counsel
(Passthroughs & Special Industries)

Enclosures (2)

Copy of this letter

Copy of this letter for section 6110 purposes